# TRANSALTA UTILITIES CORPORATION
# ANNUAL REPORT 2005

## MANAGEMENT'S DISCUSSION AND ANALYSIS

This management's discussion and analysis (MD&A) should be read in conjunction with the consolidated financial statements and Auditors' Report included in this Annual Report. The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (GAAP). All amounts in the following discussion are in millions of Canadian dollars unless otherwise noted. This MD&A is dated Feb. 16, 2006. Additional information respecting TransAlta Utilities Corporation (TransAlta Utilities or the corporation), including its annual information form, is available on SEDAR at www.sedar.com.

The corporation's financial reporting procedures and practices have enabled the certification of TransAlta Utilities' Annual Report, in compliance with the requirements of Multilateral Instrument 52-109 "Certification of Disclosure in Issuers' Annual and Interim Filings."

## OVERVIEW

We own and operate three coal and 13 hydro facilities in the province of Alberta with a total generating capacity of 3,866 megawatts (MW). Two of the coal plants representing 2,786 MW of capacity and the hydro facilities representing 801 MW of capacity are operated under the terms of an Alberta Power Purchase Arrangement (PPA), within which a single customer has the rights to the entire production of a plant or unit for the length of the PPA.

PPAs establish committed capacity and electrical energy generation requirements and availability targets to be achieved by each coal-fired plant, energy and ancillary services obligations for the hydroelectric plants, and the pricing formula at which capacity and power is supplied. We bear the risk or retain the benefit of volume variances (except for those arising from events considered to be force majeure, in the case of the coal-fired plants), and any change in costs required to maintain and operate the facilities.

Our hydroelectric facilities are not contracted on a facility-by-facility basis, rather facilities are aggregated in a single PPA which provides for energy and ancillary services obligations based on hourly targets. We meet these targeted amounts through physical delivery or third party purchases.

The remaining capacity of 279 MW is the Wabamun plant, which is a merchant plant that sells all of its production in the open market.

We measure capacity as net maximum capacity which is consistent with industry standards. Capacity figures represent capacity owned and in operation unless otherwise stated.

Some of our accounting policies require management to make estimates or assumptions that in some cases may relate to matters that are inherently uncertain. Our critical accounting policies and estimates include: revenue recognition, valuation and useful life of property, plant and equipment (PP&E); asset retirement obligations; income taxes; and employee future benefits. See additional discussion under Critical Accounting Policies and Estimates in this MD&A.

## STRATEGY AND KEY PERFORMANCE INDICATORS

Our strategy is to deliver sustainable and increasing earnings and cash flow through operations of a diversified portfolio of power generating assets. To implement this strategy, we focus on maintaining a strong balance sheet, minimizing costs, utilizing existing assets efficiently and carefully managing the risk profile.

Availability is a key driver of our financial results as approximately 90 per cent of our revenues are derived from contracts with either production or availability components. In 2005, we spent \$108.9 million on planned maintenance (2004 - \$109.8 million) and achieved fleet availability of 87.6 per cent, which is comparable to 86.5 per cent in 2004.

Long-term arrangements minimize our exposure to market price fluctuations and provide a stable stream of revenues to support fixed operating costs, pay interest and fund capital expenditures. In 2005, approximately 90 per cent of our production was sold under PPAs.

TransAlta Energy Marketing Corporation (TEM), an affiliate of the corporation, acts to maximize margins from the production and sale of electricity and reduce the risk to the corporation from unplanned outages.

We are focused on maintaining a strong balance sheet and investment grade credit ratings. At Dec. 31, 2005, our debt to invested capital ratio was 23 per cent (2004 - 27 per cent). Debt to invested capital is defined on page 6 of this MD&A.

Our key performance indicators include availability, production, fuel and operating costs and pricing applicable to non-contracted production. These are discussed in Operating Results in this MD&A. Other key performance indicators include the debt to invested capital ratio and credit ratings, which are discussed in Liquidity and Capital Resources.

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## HIGHLIGHTS

| | 2005 | 2004 |
|---|---|---|
| Availability (%) | **87.6** | 86.5 |
| Production (GWh) | **24,749** | 25,689 |

| | Amount | Amount |
|---|---|---|
| Revenues | **$ 742.5** | $ 744.8 |
| Fuel expense | **(215.1)** | (209.7) |
| Gross margin | **$ 527.4** | $ 535.1 |
| Earnings from continuing operations | **$ 172.9** | $ 167.2 |
| Earnings from discontinued operations, net of tax | **12.0** | 6.8 |
| Basic and diluted net earnings | **$ 184.9** | $ 174.0 |
| Basic and diluted earnings per share from continuing operations | **$ 1.28** | $ 1.24 |
| Basic and diluted earnings per share from discontinued operations, net of tax | **$ 0.09** | $ 0.05 |
| Net earnings per common share | **$ 1.37** | $ 1.29 |
| Cash flow from operating activities | **$ 236.8** | $ 264.8 |
| Total assets | **$3,990.8** | $ 3,888.8 |
| Total long-term financial liabilities | **$2,215.1** | $ 2,315.0 |

## SIGNIFICANT EVENTS

These consolidated financial results include the following significant events. All gains and losses discussed in this section are presented as pre-tax (after-tax) amounts.

### 2005

**Tax settlement on discontinued operations**

In the fourth quarter of 2005, we settled a tax dispute over the timing of revenue recognition related to the sale of the Distribution and Retail (D&R) operations. This settlement resulted in the release of a $12.0 million tax provision and is shown as earnings from discontinued operations on the consolidated statements of earnings.

**Tax settlement on deferred receivable**

In the third quarter of 2005, there was an income tax recovery of $13.0 million in income taxes related to prior periods due to a change in the timing of the recognition of income and the lower rate at which this income was taxed. The recovery is included in tax expense in the consolidated statements of earnings.

**Wabamun outage**

On Aug. 3, 2005, a Canadian National Railway Company (CN Rail) train derailment resulted in an oil spill into Lake Wabamun, Alberta. We were forced to shut down unit four of our Wabamun coal plant as a result. The facility was restored to full operations on Sept. 11, 2005. We estimate that we lost between $15.0 million and $18.0 million in operating income as a result of this incident.

### 2004

**Finalization of Distribution and Retail operations sale**

Effective Aug. 31, 2000, we sold our D&R operations, with a book value of $621.0 million to TransAlta Energy Corporation (TEC), an affiliate of the corporation, in exchange for $855.1 million of preferred shares of TEC which were redeemed on Sept. 29, 2000. The sale of the D&R operations to TEC constituted a related party transaction because the corporation and TEC are under common ownership. Therefore, no gain on disposal was recorded and the $234.1 million excess of the proceeds received from TEC over the net book value of the D&R operations was recorded as contributed surplus. In 2000, pursuant to a Board of Directors' resolution, the contributed surplus was reclassified to retained earnings. In 2004, a regulatory decision relating to recovery of certain costs was issued that allowed us to finalize outstanding items relating to the sale of the D&R operations. As a result, $10.2 million of unused provision against closing costs has been released to income as an after-tax gain on disposal of discontinued operations ($6.8 million). In addition, the redemption value of the preferred shares has been reduced by $10.2 million which, pursuant to the resolution of the Board of Directors, has been recorded as a charge to retained earnings. These adjustments were not made prior to 2004 as we were awaiting a regulatory decision in order to finalize the purchase price.

**Finalization of Transmission operations sale**

We sold our Transmission operations, with a book value of $632.8 million, to TEC, an affiliate of the corporation, on April 22, 2002. In exchange, we received preferred shares of TEC that were redeemable for $818.2 million. The sale of the Transmission operations to TEC constituted a related party transaction and therefore no gain on disposal was recorded. These preferred shares were redeemed on May 31, 2002 and the difference between the book value of the Transmission operations and the preferred shares was recorded as an adjustment to contributed surplus. In 2002, pursuant to a Board of Directors' resolution, the contributed surplus was reclassified to retained earnings. In June 2004, a settlement was reached to finalize the sale of the Transmission operations which resulted in an adjustment to the redemption value of the preferred shares of $2.1 million. The $2.1 million increased the redemption value of the preferred shares to $820.3 million and pursuant to a resolution of the Board of Directors, the adjustment has been charged to retained earnings.

**Preferred share investment**

In June 2004, we acquired a US$255.2 million (Cdn$295.9 million at Dec. 31, 2005) preferred share investment in TEC using funds from a loan from TransAlta Corporation (TAC), the corporation's parent. The preferred shares bear a dividend rate of 5.8 per cent per annum and are redeemable at the option of the holder or issuer.

**Wabamun plant**

On Dec. 31, 2004, we decommissioned units one and two of the Wabamun plant (62 MW and 57 MW, respectively). We plan to retire unit four in 2010 when its operating license expires. The PPA for the plant expired on Dec. 31, 2003 and production is now sold on the spot market.

## OPERATING RESULTS

Availability for 2005 of 87.6 per cent increased slightly from 86.5 per cent in 2004 primarily due to lower planned maintenance and lower unplanned outages at the Alberta Thermal plants.

Production decreased in 2005 by 940 gigawatt-hours (GWh) to 24,749 GWh compared to 2004 as a result of the decommissioning of units one and two of the Wabamun plant (858 GWh), lower production due to the CN Rail train derailment (208 GWh), and lower excess energy sold (107 GWh), partially offset by increased hydro volumes (339 GWh) and favourable unplanned outages (134 GWh).

Operating results were as follows:

| | 2005 | 2004 |
|---|---|---|
| Revenues | **$ 742.5** | $ 744.8 |
| Fuel expense | **(215.1)** | (209.7) |
| Gross margin | **527.4** | 535.1 |
| Operations, maintenance and administration | **231.2** | 220.8 |
| Depreciation and amortization | **88.1** | 82.1 |
| Taxes, other than income taxes | **7.4** | 7.4 |
| Operating income[1] | **$ 200.7** | $ 224.8 |

*1 Operating income is not defined under GAAP. Refer to the Non-GAAP measures section of this MD&A for a further discussion of operating income, including a reconciliation to net earnings.*

Revenues for the year ended Dec. 31, 2005 decreased slightly from the same period in 2004 primarily due to the decommissioning of units one and two of the Wabamun plant ($47.0 million) and the CN Rail train derailment ($10.2 million) offset by improved pricing and production at Hydro ($34.1 million), lower unplanned outages at the Alberta Thermal plants and increases to the indices within the Alberta PPAs.

Fuel costs for the year ended Dec. 31, 2005 increased by $5.4 million compared to the same period of 2004. This increase is due to increased coal costs primarily as a result of increased overburden removal costs ($24.5 million) partially offset by the decommissioning of units one and two of the Wabamun plant ($17.7 million) and lower production due to the CN Rail train derailment ($3.0 million).

Operations, maintenance and administration expense (OM&A) for 2005 increased by $10.4 million to $231.2 million primarily as a result of higher insurance and labour costs.

Depreciation and amortization expense increased by $6.0 million in 2005 compared to the same period in 2004 due to equipment retired during planned maintenance activity.

## INTEREST INCOME

| | 2005 | 2004 |
|---|---|---|
| Interest income - preferred share investment in TEC | **$ 139.6** | $ 131.4 |
| Other interest income | **20.9** | 20.1 |
| Total interest income | **$ 160.5** | $ 151.5 |

Interest income from preferred shares represents dividends earned on our preferred share investment in TEC. In 2005, interest income on preferred shares increased by $8.2 million as compared to 2004. This increase was primarily the result of a full year of interest received on our US$255.2 million (Cdn$295.8 million) preferred share investment in TEC which occurred in the second quarter of 2004.

Other interest income from advances to TAC for 2005 is comparable to 2004.

## INTEREST EXPENSE

| | 2005 | 2004 |
|---|---|---|
| Interest expense - preferred securities | **$ 138.7** | $ 138.6 |
| Interest on long-term debt | **56.8** | 56.3 |
| Total interest expense | **$ 195.5** | $ 194.9 |

During 2005 total interest expense, including preferred securities distributions was comparable to 2004.

## INCOME TAXES

| | 2005 | 2004 |
|---|---|---|
| Earnings before income taxes | **$ 165.7** | $ 181.4 |
| Earnings from discontinued operations | **–** | 10.2 |
| Interest income - preferred share investment in TEC | **(139.6)** | (131.4) |
| Taxable earnings | **$ 26.1** | $ 60.2 |
| Income taxes | **$ (7.2)** | $ 14.2 |
| Income taxes on discontinued operations | **(12.0)** | 3.4 |
| Total income taxes | **$ (19.2)** | $ 17.6 |
| Effective income tax rate | **(73.6%)** | 29.2% |

We receive dividend income from TEC which is included in interest income but is not subject to income taxes under Canadian income tax regulations.

Income tax expense decreased by $24.8 million in 2005 over 2004 due to a $13.0 million recovery in 2005 related to prior periods that was due to a change in the timing of the recognition of income and the lower rate at which this income was taxed. Income tax expense in 2005 was also lower due to adjustments to the timing of deductibility of certain expenditures related to planned maintenance and mining activity.

We also settled a dispute over the timing of revenue recognition related to the sale of the D&R business. The settlement resulted in the release of a $12.0 million tax provision related to the sale and is shown as earnings from discontinued operations on the consolidated statements of earnings and retained earnings.

## OUTLOOK

The key factors affecting our financial results for 2006 are the MW capacity in place, the availability of and production from generating assets, the costs of production and the margins applicable to non-contracted production.

The following factors will be influenced by, but not limited to, certain risks and uncertainties. For further discussion, see Risk Factors and Risk Management in this MD&A.

### Production and availability

Production is expected to increase in 2006 compared to 2005 due to a full year of production from unit four of the Wabamun plant which was forced to shutdown in the third quarter of 2005 due to the CN Rail train derailment. Availability is expected to be slightly lower than 2005 due to higher planned maintenance in 2006.

### Power prices

Production from the Wabamun plant is sold on the spot market. Electricity spot prices in Alberta for 2006 are expected to be comparable to those realized in 2005. The Alberta market should see minimal supply additions and good demand growth, while average hydro reservoir levels should keep the power price relatively unchanged year over year. Gas price strength is expected to continue with downward pressure a possibility later in the year when the current heating season comes to a close. Our assumption is that 2006 gas prices will be similar to those achieved in 2005. Alberta and the Pacific Northwest markets should see minimal supply additions and good demand growth, while average hydro reservoir levels in the Pacific Northwest should keep power prices in both markets relatively unchanged year over year.

### Costs of production

Fluctuations in the cost of coal are minimized through ownership of reserves in Alberta. OM&A costs fluctuate by quarter and are dependent on the timing and nature of maintenance activities. OM&A costs for 2006 are expected to remain consistent compared to 2005.

**Net interest expense**
Net interest expense for 2006 is expected to decline slightly compared to 2005 as a result of lower debt levels.

**Cash requirements**
In 2006, cash will be provided by a combination of cash flow from operations and utilization of credit facilities. Capital expenditures for 2006 are approximately $105 to $115 million of which approximately $65 million will be spent on planned maintenance and $20 million will be spent at our Alberta coal mines. The remainder will be spent on productivity related investments.

**Income tax expense**
We expect the tax rate for 2006, excluding dividend income not subject to tax, to be close to the statutory rate of 34 per cent.

**Climate change**
On Dec. 16, 2002, the Canadian government ratified the Kyoto Protocol, which came into effect on Feb. 16, 2005. We are not able to estimate the full impact the Kyoto Protocol will have on our operations, as the Canadian government has not yet established the regulatory requirements. However, the PPAs for our coal-fired plants contain 'Change of Law' provisions that will provide an opportunity to recover compliance costs from the PPA customers.

## CONSOLIDATED BALANCE SHEETS

The following chart outlines significant changes in the consolidated balance sheets between Dec. 31, 2005 and Dec. 31, 2004:

| | Increase/ (Decrease) | Explanation |
|---|---|---|
| Cash | $ – | Refer to Statement of Cash Flows. |
| Accounts receivable | 29.6 | Increased amounts due from affiliates. |
| Loan receivable from TAC | 49.0 | Advances made to TAC. |
| Interest receivable from TEC | 48.3 | Accrual of interest receivable from TEC on $630.0 million of preferred shares. |
| Income taxes receivable | (13.9) | Refunds of prepayments made in prior year's offset by tax refunds expected in 2006 from favourable resolution of audit issues. |
| Long-term receivable from TEC | (16.9) | Change in exchange rate on preferred shares in TEC in the amount of US$255.2 million. |
| Short-term debt | (15.1) | The receipt of a demand loan from TAC of US$256.0 million. |
| Accounts payable, accrued liabilities and other | 43.0 | Increase in due to affiliates. |
| Long-term debt (including current portion) | (84.1) | Long-term debt has decreased primarily due to the maturity of the $83.4 million debenture with TAC. |
| Future income tax liabilities | (25.3) | Favourable resolution of audit issues. |
| Common shareholders' equity | 184.9 | Net earnings for the period and the tax recovery related to prior periods and the settlement of a dispute over the timing and revenue recognition related to the sale of the D&R operations. |

## LIQUIDITY AND CAPITAL RESOURCES

| | 2005 | 2004 | Explanation |
|---|---|---|---|
| Cash, beginning of period | **$ –** | $ 8.5 | |
| Cash provided by (used in): | | | |
| Operating activities | **236.8** | 264.8 | In 2005, cash inflows were generated from cash earnings partially offset by working capital balances. In 2004, cash inflows were generated from cash earnings and improved working capital balances. |
| Investing activities | **(156.1)** | (471.6) | In 2005, cash outflows resulted from advances made to TAC of $49.0 million and capital expenditures primarily related to maintenance of $107.1 million. In 2004, cash outflows resulted from the purchase of preferred shares in TEC for US$255.2 million, advances made to TAC of $74.2 million and capital expenditures primarily related to maintenance of $86.8 million. |
| Financing activities | **(80.7)** | 198.3 | The cash outflow in 2005 resulted primarily from the repayment of long-term debt. The cash inflow in 2004 primarily resulted from issuance of the demand loan to TAC, partially offset by repayment of the $100.0 million debenture with TAC. |
| Cash, end of period | **$ –** | $ – | |

## FINANCING ARRANGEMENTS

In 2006, cash is expected to be provided by a combination of cash flow from operations and utilization of available credit facilities. Cash requirements include maintenance, additions to capital assets and repayment of short-term and maturing senior debt.

We have a $50.0 million non-committed bank credit facility that can be used for general operating and capital purposes as well as for the issuance for letters of credit. At Dec. 31, 2005, $50.0 million was utilized for the issuance of letters of credit (2004 - $49.7 million). The letters of credit expire in 2006. No guarantees or surety bonds were outstanding at Dec. 31, 2005.

At Dec. 31, 2005, we had a working capital ratio of 116 per cent compared to 103 per cent at Dec. 31, 2004. We expect to have sufficient sources of internal and external capital to finance operations and growth in the short and long-term.

## DEBT STRUCTURE

Our capital is raised by TAC. At Dec. 31, 2005, borrowings were comprised of the following:

| | Outstanding | Interest rate[1] | Maturity |
|---|---|---|---|
| Preferred securities | **$1,800.0** | **7.7%** | **2050 and 2052** |
| Debentures | **515.1** | **6.1%** | **2006-2033** |
| Total | **$2,315.1** | | |

1 *Interest is an average rate weighted by principal amounts outstanding.*

The debentures include $150.0 million held by TAC. The remainder of the debentures are directly issued to the capital markets. The preferred securities balance represents $1.1 billion and $700.0 million due in 2050 and 2052, respectively.

Our target is to maintain a capital structure and coverage ratios consistent with investment grade credit ratings. Our capital structure consisted of the following components at Dec. 31, 2005 and 2004:

| | 2005 | | 2004 | |
|---|---|---|---|---|
| Debt, net of cash | **$ 814.5** | **23%** | $ 913.7 | 27% |
| Preferred securities | **1,800.0** | **52%** | 1,800.0 | 53% |
| Common shareholders' equity | **884.6** | **25%** | 699.7 | 20% |
| Total | **$3,499.1** | **100%** | $ 3,413.4 | 100% |

At Dec. 31, 2005, our total debt to invested capital ratio was 23 per cent as compared to 27 per cent at Dec. 31, 2004. Debt to invested capital is defined as net debt, divided by net debt plus preferred securities plus common shareholders' equity. Net debt is defined as short-term debt plus long-term debt less cash.

Additional key financial ratios were as follows:

| | 2005 | 2004 |
|---|---|---|
| Cash flow to interest[1] | 8.9x | 6.9x |
| Cash flow to total debt[2] | 32% | 31% |

1 *Cash flow from operations before changes in working capital plus interest expense less interest income divided by interest expense less interest income.*

2 *Cash flow from operations before changes in working capital divided by two-year average of total debt (excluding preferred securities).*

Contractual repayments of long-term debt, commitments under operating leases and commitments under mining agreements are as follows:

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 and thereafter | Total |
|---|---|---|---|---|---|---|---|
| Long-term debt | $ 100.0 | $ – | $ 115.0 | $ 150.0 | $ – | $ 1,950.1 | $ 2,315.1 |
| Operating leases | 3.3 | 2.1 | 1.1 | 0.6 | 0.2 | 0.2 | 7.5 |
| Mining agreements | 8.8 | 8.9 | 5.3 | 5.4 | 5.3 | 71.5 | 105.2 |
| Total contractual obligations | $ 112.1 | $ 11.0 | $ 121.4 | $ 156.0 | $ 5.5 | $ 2,021.8 | $ 2,427.8 |

In the normal course of operations, we enter into agreements to provide financial or performance assurances to third parties. This includes guarantees, letters of credit and surety bonds which are entered into to support or enhance creditworthiness in order to facilitate the extension of sufficient credit for construction projects and equipment purchases.

At Dec. 31, 2005, we had $65.7 million (2004 - $59.8 million) in letters of credit outstanding. All letters of credit expire in 2006. No guarantees or surety bonds were outstanding at Dec. 31, 2005.

**Credit ratings**

In December 2005, Dominion Bond Rating Service (DBRS) confirmed a rating of A (low) to our secured debentures. In February 2006, Standard and Poor's (S&P) increased our credit rating from BBB- to BBB.

| | S&P | DBRS |
|---|---|---|
| Issuer rating | BBB | N/A |
| Secured debt | BBB+ | A (low) - Stable |

On Feb. 16, 2006, we had 135.0 million common shares outstanding in the amount of $250.9 million.

## OFF-BALANCE SHEET ARRANGEMENTS

Disclosure is required of all off-balance sheet arrangements such as transactions, agreements or contractual arrangements with unconsolidated entities, structured finance entities, special purpose entities or variable interest entities that are reasonably likely to materially affect liquidity or the availability of, or requirements for, capital resources. We have no such off-balance sheet arrangements.

In compliance with GAAP, derivatives used in hedging relationships are not recorded on the balance sheet. Gains or losses during the term of the hedge are deferred and recognized in earnings in the same period and financial statement caption as the hedged exposure (settlement accounting). The corporation also enters into long-term electricity sale and transportation agreements in the normal course of operations. These contracts are not recorded on the balance sheet as is in accordance with GAAP.

## RELATED PARTY TRANSACTIONS

As discussed in Significant Events, in June 2004, we acquired a US$255.2 million preferred share investment in TEC using funds from a loan from TAC. The preferred shares bear a dividend rate of 5.8 per cent per annum and are redeemable at the option of the holder or issuer.

During the year, we engaged in related party transactions with TAC and TEC. These transactions were recorded at their exchange amounts and settled under commercial terms. The exchange amounts are estimated based on rates and terms which would have been used for similar transactions with third parties or the amounts approximate cost.

## RISK FACTORS AND RISK MANAGEMENT

We use a multi-level risk management oversight structure to manage the corporation's various risks and exposures.

The Audit and Environment (A&E) Committee provides assistance to the Board of Directors in fulfilling its oversight responsibility relating to the integrity of the corporation's financial statements and the financial reporting process; the systems of internal accounting and financial controls; the internal audit function; the external auditors' qualifications, independence, performance and reports and the legal and environmental compliance programs as established by management and the Board of Directors.

The Exposure Management (EM) Committee is chaired by the Chief Financial Officer and is comprised of the Directors of Financial Operations for each business unit, the Executive Vice-President of Commercial Development and Marketing, Vice-President and Treasurer, Vice-President and Comptroller and the Director of Risk Management. The EM Committee is responsible for the review, monitoring and reporting on compliance of these financial and commodity risk exposure management policies.

The following addresses some, but not all, risk factors that could affect our future results. A discussion of critical estimates made in the application of accounting policies is provided in the Critical Accounting Policies and Estimates section that follows.

**COMMODITY PRICE RISK** We have exposure to movements in commodity prices, including the market price of electricity and the coal used to produce electricity. Coal used in electricity generation is from our coal reserves. This limits our exposure to fluctuations in the market price of coal.

Our coal-fired plants (other than Wabamun) and hydro electric facilities operate under the PPAs which, among other things, establish the price at which power will be supplied. In addition to the PPAs we have entered into a variety of short and long-term contracts to minimize its exposure to short-term fluctuations in electricity prices. In the event of a planned or unplanned plant outage or other similar event, however, we are exposed to changes in electricity prices on purchases of electricity from the market to fulfill our supply obligations under these short and long-term contracts. We actively seek to mitigate this exposure through continued and proper maintenance of our electricity generating plants, force majeure clauses negotiated in our contracts, trading activities and insurance.

In 2006, electricity generation from the Wabamun plant will be exposed to price fluctuations of electricity sold to the market, however, approximately 90 per cent of total output will remain fixed at contractual prices.

**FOREIGN CURRENCY EXPOSURE** We may have exposures to foreign currencies as a result of our acquisition of equipment and services. These exposures are hedged through the use of foreign currency forward purchase contracts.

**CREDIT RISK** If the counterparties to our contracts are unable to meet their obligations, our revenues could be adversely affected. We actively manage our exposure to credit risk by assessing the ability of counterparties to fulfill their obligations under the related contracts prior to entering into such contracts. We are exposed to minimal credit risk for PPAs because under the terms of these arrangements, all receivables are secured by letters of credit.

**INTEREST RATE EXPOSURE** We have exposure to declines in short-term interest rates from having floating rate debt to TAC. At Dec. 31, 2005, we had no floating rate debt. We are also exposed to declines in long-term interest rates, as PPA revenue is in part indexed to the yield on long-term Government of Canada bonds.

**HYDRO RISK** Our hydro operations financial performance is partially dependent upon the availability of water in a given year. The availability of water is difficult to forecast as it is driven by non-controllable factors, primarily weather, which impact the volume, timing and location of precipitation throughout the province of Alberta. Such water availability introduces a degree of volatility in revenues earned on our hydro operations from year to year. This risk is complicated by obligations imposed within the PPA applicable to our hydro plants. A monthly financial obligation must be paid to the PPA Buyer, based on a predetermined quantity of energy and ancillary services at market prices, regardless of our ability to generate such quantities. We manage these risks on a real-time basis by monitoring water resources throughout Alberta to the best of our ability, and optimizing this resource against real-time electricity market opportunities. We also play an important role in the management of water flows and levels in several key areas of Alberta including two major cities. We carefully balance all of these factors together to achieve optimal productivity with the water resources available.

**OPERATIONAL RISK** Our plants have exposure to operational risks such as fatigue cracks in boilers, corrosion in boiler tubing, turbine failures and other issues that can lead to outages. A comprehensive plant maintenance program and regular turnarounds reduce this exposure. If the plants do not meet the availability or production targets specified in the PPAs then we must compensate the purchaser for the loss in the availability of production. Consequently, an extended outage could have a material adverse effect on our business, financial condition, results of operations, or cash flows. Insurance and force majeure clauses in the PPAs further mitigate this exposure.

Approximately 70 per cent of our labour force is covered under collective bargaining agreements. We are currently a party to two different collective bargaining agreements.

The construction and development of generating facilities and acquisition activities are subject to various environmental, engineering and construction risks relating to cost-overruns, delays and performance. We attempt to minimize these risks by performing detailed analysis of project economics prior to construction or acquisition and by securing favourable power sales agreements.

**ENVIRONMENTAL, HEALTH AND SAFETY RISK** Our approach to managing our environmental, health and safety (EHS) risk has three elements:

- Compliance-based activities, such as permitting and reporting,
- ISO-based EHS Management systems and programs, such as safety programs and auditing,
- Longer-term strategic initiatives, including climate change and government policy development.

These elements are integrated into our corporate-wide operations and management systems. They are designed to mitigate all risks of our activities to employees, the public and the environment, and to address potential competitive risks from future changes in environmental policy. They are also supportive of our corporate commitment to sustainability.

We strive to maintain compliance with all environmental regulations relating to operations and facilities. Quarterly reports on all EHS regulatory changes are provided to each facility to ensure compliance is maintained and we produce and distribute quarterly and annual public reports on our performance. We seek continuous improvement in numerous performance metrics such as emissions, safety, land and water impacts, and environmental incidents.

We have implemented an ISO-based EHS management system, designed to continuously improve environmental and safety performance. All of our plants have implemented the system. Compliance with both regulatory requirements and management system standards is regularly audited through our Performance Assurance Policy and results are reported quarterly to our Board of Directors.

We commit significant effort to working with regulators in Canada to ensure regulatory changes are well-designed and cost-effective. New emission reduction objectives for the power sector are being established by the Canadian government. We have compliance plans over the next decade for greenhouse gases, mercury, sulphur dioxide and oxides of nitrogen, which will be adjusted as regulations are finalized. Where capital investment for control equipment may be required, we have technology review processes underway.

Specifically on climate change, the corporation has implemented a four-component strategy that manages future risk associated with climate change regulation and develops competitive business advantages. The cornerstones of the strategy are:

1. Internal operational improvements which lower the emissions of our generation operations. These include plant upgrades, intensive equipment maintenance, efficiency improvements and fuel decision choices.
2. Purchase of emission reduction offsets outside our operations. TransAlta Corporation (including TransAlta Utilities) has been a Canadian leader in this area and has created an offsets portfolio that will allow us to meet emission targets at competitive costs.
3. Renewable energy investments particularly in the wind area, which reduce our emissions intensity and diversify our fuel mix, and
4. Investments in clean coal technology development which provide long-term promise for large emission reductions from fossil-fired generation. TransAlta Corporation is a founder of the Canadian Clean Power Coalition, an industry consortium developed to build Canada's first clean coal power plant.

We anticipate continued and growing scrutiny by investors relating to sustainability performance. Our reputation as a leader in this area is important, more so because in our opinion it represents both good management and competitive positioning. The Dow Jones Sustainability Index has again recognized TransAlta Corporation (including TransAlta Utilities) as one of the world's best utility companies in terms of sustainability performance. In 2005, we were also recognized as one of the world's top 100 sustainable companies in the Global 100 ranking of the World Economic Forum.

**REGULATORY AND POLITICAL RISK** Regulatory and political risks exist in Alberta. We are not able to predict whether there will be any changes in the regulatory environment or the ultimate effect of changes in the regulatory environment on the business. We manage these risks by working with regulators, governments, agencies, and other stakeholders to identify and attempt to resolve issues as fairly and expeditiously as possible. A wholesale market review task force and a retail market review were initiated in Alberta in 2004 to evaluate the functioning of the electricity market and consider market design changes. A market design policy was released in 2005. We continue to work with regulators and agencies to ensure any regulatory changes are well-designed and cost-effective. New draft regulations are expected in 2006 and the operational and financial impact of these regulations on all Alberta plants and trading operations will need to be assessed. Outcomes may include, but are not limited to: increased compliance, operating or capital costs, reduced operational flexibility, or reduced power prices and volatility.

**TRANSMISSION RISK** In August 2003, a blackout cut off electricity to millions of residents in the Northeastern U.S. and Eastern Canada. This type of event, although extremely unusual, is an ongoing risk for electric companies. This risk is mitigated through force majeure clauses in the PPAs and access to multiple transmission lines. Transmission constraints within Alberta limit opportunities for exports, generation additions and uprates at existing generating facilities. We manage this risk by intervening in and supporting applications for transmission upgrades and additional transmission construction. We also work closely with agencies and other stakeholders to identify and resolve transmission issues as they arise.

**GENERAL ECONOMIC CONDITIONS** Changes in general economic conditions impact product demand, revenue, operating costs, timing and extent of capital expenditures, the net recoverable value of property, plant and equipment, results of financing efforts, credit risk and counterparty risk.

**INCOME TAXES** Our operations are complex, and the computation of the provision for income taxes involves tax interpretations, regulations and legislation that are continually changing. Our tax filings are subject to audit by taxation authorities. Management believes that it has adequately provided for income taxes based on all information currently available.

**LEGAL CONTINGENCIES** We are occasionally named as a defendant in various claims and legal actions. Exposure to these claims is mitigated through levels of insurance coverage considered appropriate by management and active management of these claims. Except as disclosed in Note 18 to the consolidated financial statements, we do not expect the outcome of the claims or potential claims to have a materially adverse effect on us given the nature of the claims, the amounts in dispute or claimed and the availability of insurance.

**OTHER CONTINGENCIES** We maintain a level of insurance coverage deemed appropriate by management. There were no significant changes to our insurance coverage during 2005.

## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The selection and application of accounting policies is an important process that has developed as our business activities have evolved and as accounting rules have changed. Accounting rules generally do not involve a selection among alternatives, but involve an implementation and interpretation of existing rules and the use of judgment relative to the circumstances existing in our business. Every effort is made to comply with all applicable rules on or before the effective date, and we believe the proper implementation and consistent application of accounting rules is critical. However, not all situations are specifically addressed in the accounting literature. In these cases, our best judgment is used to adopt a policy for accounting for these situations. This is accomplished by analogizing to similar situations and the accounting guidelines governing them, consideration of foreign accounting standards and consultation with our independent auditors about the appropriate interpretation and application of these policies. Each of the critical accounting policies involves complex situations and a high degree of judgment either in the application and interpretation of existing literature or in the development of estimates that impact our consolidated financial statements.

Our significant accounting policies are described in Note 1 to the consolidated financial statements. The most critical of these policies are those related to property, plant and equipment, asset retirement obligations, income taxes and employee future benefits (Notes 1(F), (G), (H) and (I), respectively). Each policy involves a number of estimates and assumptions to be made by management about matters that are highly uncertain at the time the estimate is made. Different estimates, with respect to key variables we used for the calculations, or changes to estimates could potentially have a material impact on our financial position or results of operations. These critical accounting estimates are described below.

Management has discussed the development and selection of these critical accounting estimates with the Audit and Environment (A&E) Committee and our independent auditors. The A&E Committee has reviewed and approved our disclosure relating to critical accounting estimates in this MD&A.

### Revenue recognition

The majority of our revenues are derived from the production of power in Alberta. Revenues under Alberta PPAs generally include one or more of the following components: fixed capacity payments for being available; energy payments for generation of electricity; availability incentives or penalties for exceeding or not meeting availability targets; excess energy payments for power generation above committed capacity; and ancillary services. Each is recognized upon output, delivery, or satisfaction of specific targets, as specified by contractual terms. Revenues from non-contracted capacity are comprised of energy payments for each MWh produced at market prices, and are recognized upon delivery.

### Valuation of property, plant and equipment

Property, plant and equipment (PP&E) makes up 35 per cent of our assets. On an annual basis, and when indicators of impairment exist, we determine whether the net carrying amount of PP&E is recoverable from future undiscounted cash flows. Factors which could indicate that an impairment exists include significant underperformance relative to historical or projected operating results, significant changes in the manner or use of the assets, significant negative industry or economic trends, or a change in the strategy for our overall business. In some cases, these events are clear. However, in many cases, a clearly identifiable event indicating possible impairment does not occur. Instead, a series of individually insignificant events occur over a period of time leading to an indication that an asset may be impaired. As a result, events occurring in these situations may not be known until a date subsequent to their occurrence.

Our businesses, the markets and business environment are continually monitored, and judgments and assessments are made to determine whether an event has occurred that indicates possible impairment. If such an event has occurred, an estimate is made of the future undiscounted cash flows from the asset. If the total of the undiscounted future cash flows, excluding financing charges, is less than the carrying amount of the asset, an asset impairment charge must be recognized in the financial statements. The amount of the impairment recognized is calculated by subtracting the fair value of the asset from the carrying value of the asset. Fair value is the amount at which an item could be bought or sold in a current transaction between willing parties, and is best estimated by calculating the net present value of future expected cash flows related to the asset. Both the identification of events that may trigger an impairment and the estimates of future cash flows and the fair value of the asset require considerable judgment.

The assessment of asset impairment requires management to make significant assumptions about future sales prices, cost of sales, production and fuel consumed over the life of the plants (up to 30 years), retirement costs and discount rates. In addition, when impairment tests are performed, the estimated useful lives of the plants are reassessed, with any change accounted for prospectively.

In estimating future cash flows of the plants, we use estimates of contracted and future market prices based on expected market supply and demand in the region in which the plant operates, anticipated production levels, planned and unplanned outages, and transmission capacity or constraints for the remaining life of the plant. Actual results can, and often do, differ from the estimates, and can have either a positive or negative impact on the estimate of the impairment charge, and may be material.

The results of our annual impairment review showed no indications of impairment.

### Asset retirement obligations

We recognize asset retirement obligations for PP&E in the period in which they are incurred if a reasonable estimate of a fair value can be determined. The fair value of the liability is described as the amount at which the liability could be settled in a current transaction between willing parties. Expected values are probability weighted to deal with the risks and uncertainties inherent in the timing and amount of settlement of many asset retirement obligations. Expected values are discounted at the risk-free interest rate adjusted to reflect the market's evaluation of the entity's credit standing. Determining asset retirement obligations requires estimating the life of the related asset and the costs of activities such as demolition, dismantling, restoration and remedial work based on present day methods and technologies.

At Dec. 31, 2005, the asset retirement obligations recorded on the consolidated balance sheet were $101.5 million. We estimate the undiscounted amount of cash flow required to settle the obligations is approximately $377.8 million, which will be incurred between 2007 and 2072. The majority of these costs will be incurred between 2020 and 2030.

Sensitivities for the major assumptions are as follows:

| Assumption | Change in assumption | Impact on pre-tax earnings |
|---|---|---|
| Discount rate | 1% | $ 0.6 |
| Undiscounted asset retirement obligations | 1% | 0.1 |

### Useful life of property, plant and equipment

PP&E is depreciated over its estimated useful life. Estimated useful lives were determined based on current facts and past experience, and take into consideration the anticipated physical life of the asset, existing long-term sales agreements and contracts, current and forecasted demand and the potential for technological obsolescence. Major components of plants are depreciated over their own useful lives. A component is a tangible asset that can be separately identified as an asset, and is expected to provide a benefit of greater than one year.

Depreciation and amortization expense was $105.1 million in 2005, of which $25.3 million relates to mining equipment, and is included in fuel expense.

The rates used are reviewed on an ongoing basis to ensure they continue to be appropriate, and are also reviewed in conjunction with impairment testing, as discussed above.

### Income taxes

In accordance with GAAP, we use the liability method of accounting for future income taxes and provide future income taxes for all significant income tax temporary differences.

Preparation of the consolidated financial statements requires an estimate of income taxes in the jurisdictions in which the corporation operates. The process involves an estimate of our actual current tax exposure and an assessment of temporary differences resulting from differing treatment of items, such as depreciation and amortization, for tax and accounting purposes. These differences result in future tax assets and liabilities which are included in our consolidated balance sheet.

An assessment must also be made to determine the likelihood that our future tax assets will be recovered from future taxable income. To the extent that recovery is not considered likely, a valuation allowance must be determined. Judgment is required in determining the provision for income taxes, future income tax assets and liabilities and any related valuation allowance. To the extent a valuation allowance is created or revised, current period earnings will be affected.

Future tax assets of $9.0 million have been recorded on the consolidated balance sheet at Dec. 31, 2005. This relates primarily to employee benefit obligations. Future tax liabilities of $172.7 million have been recorded on the consolidated balance sheet at Dec. 31, 2005. The liability is comprised primarily of income tax deductions in excess of related depreciation of PP&E, partially offset by asset retirement obligation costs.

Judgment is required to assess tax interpretations, regulations and legislation, which are continually changing, to ensure liabilities are complete and to ensure assets, net of valuation allowances, are realizable. The impact of different interpretations and applications could potentially be material.

Our tax filings are subject to audit by taxation authorities. The outcome of some audits may change our tax liability, although management believes that it has adequately provided for income taxes based on all information currently available. The outcome of the audits is not known, nor is the potential impact on the financial statements determinable.

**Employee future benefits**

We have a registered pension plan with defined benefit and defined contribution options and a supplemental defined benefit plan covering substantially all our employees. The defined benefit option of the registered pension plan ceased for new employees on June 30, 1998. The latest actuarial valuations of the registered and supplemental pension plans were as at Dec. 31, 2005. The supplemental pension plan is our obligation. We are not obligated to fund the supplemental plan but are obligated to pay benefits under the terms of the plan as they come due.

We provide other health and dental benefits to the age of 65 for both disabled members (other post-employment benefits) and retired members (other post-retirement benefits). The latest actuarial valuation of these other plans was as at Dec. 31, 2004.

The cost of providing these benefits is dependent upon many factors which result from actual plan experience and assumptions of future experience.

The liability for future benefits and associated pension costs included in annual compensation expenses are impacted by employee demographics, including age, compensation levels, employment periods, the level of contributions made to the plans and earnings on plan assets. Changes to the provisions of the plans may also affect current and future pension costs. Pension costs may also be significantly impacted by changes in key actuarial assumptions, including anticipated rates of return on plan assets and the discount rates used in determining the projected benefit obligation and pension costs.

The plan assets are comprised primarily of equity and fixed income investments. Fluctuations in actual equity market returns and changes in interest rates may result in increased or decreased pension costs in future periods.

The expected long-term rate of return on plan assets is based on past performance and economic forecasts for the types of investments held by the plan. For the year ended Dec. 31, 2005, the plan assets had a return of $40.7 million compared to a return of $29.4 million in 2004. The 2005 actuarial valuation used a rate of return on plan assets of 7.0 per cent (2004 - 7.0 per cent).

## NON-GAAP MEASURES

We evaluate our performance using a variety of measures. Those discussed below are not defined under GAAP and therefore should not be considered in isolation or as an alternative to, or more meaningful than, net income or cash flow from operations as determined in accordance with GAAP as an indicator of the corporation's financial performance or liquidity. These measures are not necessarily comparable to a similarly titled measure of another company.

Operating income is a measure of financial performance used by our analysts and investors to analyze and compare companies on the basis of operating performance.

Gross margin less operating expenses and operating income provide management with a measurement of operating performance which is readily comparable from period to period.

Gross margin less operating expenses and operating income are reconciled to net earnings below:

| | 2005 | 2004 |
|---|---|---|
| Gross margin | **$ 527.4** | $ 535.1 |
| Operating expenses | **326.7** | 310.3 |
| Operating income | **200.7** | 224.8 |
| Interest expense | **(195.5)** | (194.9) |
| Interest income | **160.5** | 151.5 |
| Earnings from continuing operations before income taxes | **165.7** | 181.4 |
| Income tax expense | **(7.2)** | 14.2 |
| Earnings from continuing operations | **172.9** | 167.2 |
| Earnings from discontinued operations, net of tax | **12.0** | 6.8 |
| Net earnings | **$ 184.9** | $ 174.0 |

## SELECTED QUARTERLY FINANCIAL INFORMATION

***(Unaudited, in millions of Canadian dollars except per share amounts)***

| | Q1 2005 | Q2 2005 | Q3 2005 | Q4 2005 |
|---|---|---|---|---|
| Revenues | **$ 184.6** | **$ 181.7** | **$ 170.1** | **$ 206.1** |
| Earnings from continuing operations | **49.9** | **43.4** | **39.2** | **40.4** |
| Net earnings | **49.9** | **43.4** | **39.2** | **52.4** |
| Earnings per common share from continuing operations, basic and diluted | **0.37** | **0.32** | **0.29** | **0.30** |
| Earnings per common share from discontinued operations, basic and diluted | **–** | **–** | **–** | **0.09** |
| Net earnings per common share, basic and diluted | **0.37** | **0.32** | **0.29** | **0.39** |
| | **Q1 2004** | **Q2 2004** | **Q3 2004** | **Q4 2004** |
| Revenues | $ 193.3 | $ 185.5 | $ 172.6 | $ 193.4 |
| Earnings from continuing operations | 57.1 | 42.5 | 25.2 | 42.4 |
| Net earnings | 57.1 | 42.5 | 32.0 | 42.4 |
| Earnings per common share from continuing operations, basic and diluted | 0.42 | 0.31 | 0.19 | 0.32 |
| Earnings per common share from discontinued operations, basic and diluted | – | – | 0.05 | – |
| Net earnings per common share, basic and diluted | 0.42 | 0.31 | 0.24 | 0.32 |

Our results are partly seasonal due to the nature of the electricity market and related fuel costs. Higher maintenance costs are ordinarily incurred in the second and third quarters when electricity prices are expected to be lower as electricity prices generally increase in the winter months in the Canadian market. Margins are also typically impacted in the second quarter due to the volume of hydro production resulting from spring run-off and rainfall in the Canadian market.

## FORWARD-LOOKING STATEMENTS

This MD&A contains forward-looking statements, including statements regarding the business and anticipated financial performance of TransAlta Utilities. In some cases, forward-looking statements can be identified by terms such as 'may', 'will', 'believe', 'expect', 'potential', 'enable', 'continue' or other comparable terminology. These statements are not guarantees of TransAlta Utilities' future performance and are subject to risks, uncertainties and other important factors that could cause the corporation's actual performance to be materially different from those projected. Some of the risks, uncertainties, and factors include, but are not limited to: legislative and regulatory developments that could affect revenues, costs, and the speed and degree of competition entering the market; global capital markets activity; timing and extent of changes in commodity prices, prevailing interest rates, currency exchange rates, inflation levels and general economic conditions where TransAlta Utilities operates; results of financing efforts; changes in counterparty risk; and the impact of accounting policies issued by Canadian standard setters. Given these uncertainties, the reader should not place undue reliance on these forward-looking statements. See additional discussion under Risk Factors and Risk Management in this MD&A.

# TRANSALTA UTILITIES CORPORATION
# CONSOLIDATED FINANCIAL STATEMENTS

## MANAGEMENT'S RESPONSIBILITY

TransAlta Utilities' management is responsible for presentation and preparation of the annual consolidated financial statements, management's discussion and analysis (MD&A) and all other information in this annual report.

The accompanying consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles.

The MD&A has been prepared in accordance with the requirements of security regulators including National Instruments 44-101 and 51-102 of the Canadian Securities Administrators and their related published documents.

The consolidated financial statements and information in the MD&A necessarily include amounts based on informed judgments and estimates of the expected effects of current events and transactions with appropriate consideration for materiality. In addition, in preparing financial information, the corporation must interpret the requirements described above, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information. The MD&A also includes information regarding the estimated impact of current transactions and events, sources of liquidity and capital resources, operating trends, risks and uncertainties. Actual results in the future may differ materially from management's present assessment of this information because future events and circumstances may not occur as expected.

The financial information presented elsewhere in this annual report is consistent with that in the consolidated financial statements.

To meet its responsibility for reliable and accurate financial statements, management has established systems of internal control which are designed to provide reasonable assurance that financial information is relevant, reliable and accurate, and that assets are safeguarded and transactions are executed in accordance with management's authorization. These systems are monitored by management and by internal auditors. In addition, the internal auditors perform appropriate tests and related audit procedures.

The consolidated financial statements have been examined by Ernst & Young LLP, independent chartered accountants. The external auditors' responsibility is to express a professional opinion on the fairness of management's consolidated financial statements. The auditors' report outlines the scope of their examination and sets forth their opinion.

The Audit and Environment (A&E) Committee of the Board of Directors is comprised of independent directors. The A&E Committee meets regularly with management, the internal auditors and the external auditors to satisfy itself that each is properly discharging its responsibilities, and to review the consolidated financial statements and MD&A. The A&E Committee reports its findings to the Board of Directors for consideration when approving the consolidated financial statements for issuance to the shareholder. The A&E Committee also recommends, for review by the Board of Directors and approval by the shareholder, the appointment of the external auditors. The internal and external auditors have full and free access to the A&E Committee.

TransAlta Utilities' Chief Executive Officer and Chief Financial Officer have certified TransAlta Utilities' annual disclosure documents as required by the Canadian securities regulators.

Signed by

Stephen G. Snyder
*President & Chief Executive Officer*

Brian Burden
*Executive Vice-President & Chief Financial Officer*

Feb. 16, 2006

# AUDITORS' REPORT

**TO THE SHAREHOLDERS OF TRANSALTA UTILITIES CORPORATION**

We have audited the consolidated balance sheets of TransAlta Utilities Corporation as at December 31, 2005 and 2004 and the consolidated statements of earnings and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

Ernst & Young LLP

Chartered Accountants

Calgary, Canada

February 16, 2006

## TRANSALTA UTILITIES CORPORATION
## CONSOLIDATED STATEMENTS OF EARNINGS & RETAINED EARNINGS

*(in millions of Canadian dollars except per share amounts)*

| Year ended Dec. 31 | 2005 | 2004 |
|---|---|---|
| **Revenues** | $ **742.5** | $ 744.8 |
| Fuel expense | **(215.1)** | (209.7) |
| **Gross margin** | **527.4** | 535.1 |
| **Operating expenses** | | |
| Operations, maintenance and administration | **231.2** | 220.8 |
| Depreciation and amortization *(Note 18)* | **88.1** | 82.1 |
| Taxes, other than income taxes | **7.4** | 7.4 |
| | **326.7** | 310.3 |
| **Operating income** | **200.7** | 224.8 |
| Interest expense *(Note 7)* | **(195.5)** | (194.9) |
| Interest income *(Note 6)* | **160.5** | 151.5 |
| **Earnings from continuing operations before income taxes** | **165.7** | 181.4 |
| Income tax expense *(Note 12)* | **(7.2)** | 14.2 |
| **Earnings from continuing operations** | **172.9** | 167.2 |
| Earnings from discontinued operations, net of tax *(Note 2)* | **12.0** | 6.8 |
| **Net earnings** | $ **184.9** | $ 174.0 |
| **Reclassification of contributed surplus to retained earnings** *(Note 2)* | **–** | (8.1) |
| **Retained earnings** | | |
| Opening balance | **218.5** | 52.6 |
| Closing balance | $ **403.4** | $ 218.5 |
| Weighted average common shares outstanding in the year | **135.0** | 135.0 |
| **Basic and diluted earnings per common share** | | |
| Earnings from continuing operations | $ **1.28** | $ 1.24 |
| Earnings from discontinued operations | **0.09** | 0.05 |
| Net earnings | $ **1.37** | $ 1.29 |

*See accompanying notes.*

# TRANSALTA UTILITIES CORPORATION
# CONSOLIDATED BALANCE SHEETS

*(in millions of Canadian dollars)*

| Dec. 31 | 2005 | 2004 |
|---|---|---|
| **ASSETS** | | |
| **Current assets** | | |
| Accounts receivable *(Note 15)* | **$ 131.8** | $ 102.2 |
| Loan receivable from TransAlta Corporation *(Note 15)* | **354.6** | 305.6 |
| Interest receivable from TransAlta Energy Corporation *(Note 15)* | **116.6** | 68.3 |
| Inventory | **15.1** | 14.3 |
| Future income tax assets *(Note 12)* | **9.0** | 9.0 |
| Income taxes receivable | **38.1** | 52.0 |
| | **665.2** | 551.4 |
| **Property, plant and equipment** *(Note 4)* | | |
| Cost | **3,094.9** | 3,025.7 |
| Accumulated depreciation | **(1,697.1)** | (1,633.8) |
| | **1,397.8** | 1,391.9 |
| **Long-term receivable from TransAlta Energy Corporation** *(Notes 8 and 15)* | **1,925.8** | 1,942.7 |
| **Other assets** | **2.0** | 2.8 |
| **Total assets** | **$ 3,990.8** | $ 3,888.8 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| **Current liabilities** | | |
| Short-term debt *(Note 9)* | **$ 299.4** | $ 314.5 |
| Accounts payable, accrued liabilities and other *(Note 15)* | **168.9** | 125.9 |
| Income taxes payable | **5.8** | 9.1 |
| Current portion of long-term debt *(Note 10)* | **100.0** | 84.2 |
| | **574.1** | 533.7 |
| **Long-term debt** *(Note 10)* | **415.1** | 515.0 |
| **Preferred securities** *(Note 10)* | **1,800.0** | 1,800.0 |
| **Asset retirement obligations** *(Note 5)* | **101.5** | 98.1 |
| **Future income tax liabilities** *(Note 12)* | **172.7** | 198.0 |
| **Other long-term liabilities** *(Note 13)* | **42.8** | 44.3 |
| **Common shareholders' equity** | | |
| Common shares *(Note 11)* | **250.9** | 250.9 |
| Contributed surplus | **230.3** | 230.3 |
| Retained earnings | **403.4** | 218.5 |
| | **884.6** | 699.7 |
| **Total liabilities and shareholders' equity** | **$ 3,990.8** | $ 3,888.8 |

**Commitments and contingencies** *(Notes 16 and 17)*

*See accompanying notes.*

On behalf of the Board:

Donna Kaufman

Signed by

Donna Kaufman

*Director*

William D. Anderson

Signed by

William D. Anderson

*Director*

## CONSOLIDATED STATEMENTS OF CASH FLOWS

*(in millions of Canadian dollars)*

| Year ended Dec. 31 | 2005 | 2004 |
|---|---|---|
| **Operating activities** | | |
| **Net earnings** | **$ 184.9** | $ 174.0 |
| Depreciation and amortization *(Note 18)* | **105.1** | 103.0 |
| Gain on sale of assets | **–** | (11.8) |
| Future income taxes | **(12.3)** | (8.8) |
| Asset retirement obligation costs settled *(Note 5)* | **(8.5)** | (10.4) |
| Asset retirement obligation accretion *(Note 5)* | **8.4** | 8.4 |
| | **277.6** | 254.4 |
| Change in non-cash operating working capital balances | **(40.8)** | 10.4 |
| Cash flow from operating activities | **236.8** | 264.8 |
| **Investing activities** | | |
| Additions to property, plant and equipment | **(107.1)** | (86.8) |
| Proceeds on the sale of property, plant and equipment | **–** | 2.1 |
| Loan receivable from TransAlta Corporation | **(49.0)** | (74.2) |
| Purchase of preferred shares in TransAlta Energy Corporation | **–** | (312.7) |
| Cash flow from (used in) investing activities | **(156.1)** | (471.6) |
| **Financing activities** | | |
| Net proceeds from issuance of short-term debt | **3.5** | 314.5 |
| Repayment of long-term debt | **(84.2)** | (105.8) |
| Distributions on preferred securities | **–** | (10.2) |
| Other | **–** | (0.2) |
| Cash flow from (used in) financing activities | **(80.7)** | 198.3 |
| **Cash flow from (used in) operating, investing and financing activities** | **–** | (8.5) |
| **Cash, beginning of year** | **–** | 8.5 |
| **Cash, end of year** | **$ –** | $ – |
| Net cash taxes paid | **$ (4.1)** | $ (6.3) |
| Net cash interest paid | **$ 132.4** | $ 94.7 |

*See accompanying notes.*

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Dec. 31, 2005 and 2004

*(Tabular dollar amounts in millions of Canadian dollars, unless otherwise noted)*

NOTE
## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**A. Consolidation**

The consolidated financial statements include the accounts of TransAlta Utilities Corporation (TransAlta Utilities or the corporation) and its wholly-owned subsidiaries. The consolidated financial statements have been prepared by management in accordance with Canadian generally accepted accounting principles (GAAP).

**B. Use of estimates and measurement uncertainty**

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Actual results could differ from those estimates due to factors such as fluctuations in interest rates, currency exchange rates, inflation levels and commodity prices, changes in economic conditions and legislative and regulatory changes *(Notes 4, 5, 13, 14 and 17).*

**C. Revenue recognition**

The majority of the corporation's revenues are derived from the production of power in Alberta. Revenues under Alberta Power Purchase Arrangements (PPA) generally include one or more of the following components: fixed capacity payments for being available, energy payments for generation of electricity, availability payments or penalties for exceeding or not meeting availability targets, excess energy payments for power generation above committed capacity and ancillary services. Each is recognized upon output, delivery, or satisfaction of specific targets, all as specified by contractual terms. Revenues from non-contracted capacity are energy payments for each megawatt hour (MWh) produced at market prices, and are recognized upon delivery.

**D. Discontinued operations**

The results of discontinued operations are presented on a one-line basis in the consolidated statements of earnings. Interest expense, direct corporate overheads and income taxes are allocated to discontinued operations. General corporate overheads are not allocated to discontinued operations.

**E. Inventory**

The corporation's inventory balance represents coal which is valued at the lower of cost and market value, defined as net replacement value. Inventory cost is determined using moving average cost. The direct costing method is and is determined as the sum of all applicable expenditures and charges directly or indirectly incurred in bringing an inventory item to its existing condition and location.

**F. Property, plant and equipment**

The corporation's investment in property, plant and equipment (PP&E) is stated at original cost at the time of construction, purchase or acquisition. Original cost includes items such as materials, labour, interest and other appropriately allocated costs. As costs are expended for new construction, the entire amount is capitalized as PP&E on the consolidated balance sheet and is subject to depreciation upon commencement of commercial operations. The cost of routine maintenance and repairs, such as inspections and corrosion removal, and the replacement of minor parts, are charged to expense as incurred. Certain expenditures relating to replacement of components incurred during major maintenance are capitalized and amortized over the estimated benefit period of such expenditures. A component is a tangible portion of the asset that can be separately identified as an asset and depreciated over its own expected useful life, and is expected to provide a benefit of greater than one year.

The estimate of the useful life of PP&E is based on current facts and past experience, and takes into consideration existing long-term sales agreements and contracts, current and forecasted demand and the potential for technological obsolescence. The useful life is used to estimate the rate at which the PP&E is amortized. These estimates are subject to revision in future periods based on new or additional information. Depreciation and amortization is calculated using straight-line, declining balance and unit of production methods. Coal rights are amortized on a unit of production basis, based on the estimated mine reserve.

TransAlta Utilities capitalizes interest on capital invested in projects that are under construction. Upon commencement of plant operations, capitalized interest, as a portion of the total cost of the plant, is amortized over the estimated useful life of the plant.

The corporation determines those debt instruments that best represent a reasonable measure of the cost of financing the assets under construction. These debt instruments and associated interest costs are included in the calculation of the weighted average interest rate used for capitalizing interest.

On an annual basis, and when indicators of impairment exist, TransAlta Utilities determines whether the net carrying amount of PP&E is recoverable from future undiscounted cash flows. Factors which could indicate an impairment exists include significant underperformance relative to historical or projected future operating results, significant changes in the manner or use of the assets, significant negative industry or economic trends, or a change in the strategy for the corporation's overall business. In some cases, these events are clear. However, in many cases, a clearly identifiable event indicating possible

impairment does not occur. Instead, a series of individually insignificant events occur over a period of time leading to an indication that an asset may be impaired. As a result, events occurring in these situations may not be known until a date subsequent to their occurrence.

The corporation's businesses, the markets and business environment are continually monitored, and judgments and assessments are made to determine whether an event has occurred that indicates possible impairment. If such an event has occurred, an estimate is made of the future undiscounted cash flows from the PP&E. If the total of the undiscounted future cash flows, excluding financing charges, is less than the carrying amount of the PP&E, an asset impairment must be recognized in the consolidated financial statements. The amount of the impairment charge to be recognized is calculated by subtracting the fair value of the asset from the carrying value of the asset. Fair value is the amount at which an item could be bought or sold in a current transaction between willing parties, and is estimated by calculating the present value of expected future cash flows related to the asset.

**G. Asset retirement obligation**

The corporation recognizes asset retirement obligations in the period in which they are incurred if a reasonable estimate of a fair value can be determined. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset. The liability is accreted over the estimated time period until settlement of the obligation and the asset is depreciated over the estimated useful life of the asset *(Note 5)*.

**H. Income taxes**

The corporation uses the liability method of accounting for income taxes. Under the liability method, income taxes are recognized for the differences between financial statement carrying values and the respective income tax basis of assets and liabilities (temporary differences), the carry-forward of unused tax losses and income tax reductions. Future income tax assets and liabilities are measured using income tax rates expected to apply in the years in which temporary differences are expected to be recovered or settled. The effect on future income tax assets and liabilities of a change in tax rates is included in income in the period the change is substantively enacted. Future income tax assets are evaluated annually and if realization is not considered 'more likely than not', a valuation allowance is provided.

**I. Employee future benefits**

The corporation accrues its obligations under employee benefit plans and the related costs, net of plan assets. The cost of pensions and other post-employment and post-retirement benefits earned by employees is actuarially determined using the projected benefit method pro-rated on services and management's best estimate of expected plan investment performance, salary escalation, retirement ages of employees and expected health care costs. The defined benefit pension plans are based on an employee's final average earnings and years of service. Pension benefits will increase annually by two per cent. For the purpose of calculating the expected return on plan assets, those assets are valued at quoted market value. The discount rate used to calculate the interest cost on the accrued benefit obligation is determined by reference to market interest rates at the balance sheet date on high-quality debt instruments with cash flows that match the timing and amount of expected benefit payments and past service costs from plan amendments are amortized on a straight-line basis over the average remaining service period of employees active at the date of amendment (EARSL). If the cumulative net unamortized gain or loss exceeds 10 per cent of the accrued benefit obligation or the market value of the plant assets, whichever is greater, the amount in excess of this 10 per cent threshold is amortized to earnings over EARSL. When the restructuring of a benefit plan gives rise to both a curtailment and settlement of obligations, the curtailment is accounted for prior to the settlement. Transition obligations and assets arising from the prospective adoption of new accounting standards are amortized over EARSL.

**J. Derivatives and financial instruments**

Physical and financial swaps, forward sales contracts and options are used to hedge the corporation's exposure to fluctuations in electricity and natural gas prices to output from the plants. Under GAAP, if hedging criteria are met (described below), gains and losses on these derivatives are deferred and recognized in earnings in the same period and financial statement caption as the hedged exposure (settlement accounting). The derivatives are not recorded on the balance sheet.

Foreign currency forward contracts are used to hedge the foreign exchange exposures resulting from anticipated contracts and firm commitments denominated in foreign currencies. Under GAAP, if hedge criteria are met, these derivatives are not recognized on the balance sheet. Upon settlement of the derivative, any gain or loss on the forward contracts is deferred and included in other assets or accounts payable, accrued liabilities and other, and is included in the cost of the asset when the asset is purchased and depreciated over the asset's estimated useful life (settlement accounting).

Interest rate swaps are used to manage the impact of fluctuating interest rates on existing debt. These instruments are not recognized on the balance sheet under GAAP. Interest rate swaps require the periodic exchange of payments without the exchange of the notional principal amount on which the payments are based. If hedge criteria are met, interest expense on the debt is adjusted to include the payments made or received under the interest rate swaps (settlement accounting).

To be accounted for as a hedge under GAAP, a derivative must be designated and documented as a hedge, and must be effective at inception and on an ongoing basis. The documentation defines all relationships between hedging instruments and hedged items, as well as the corporation's risk management objective and strategy for undertaking various hedge transactions. The process includes linking derivatives to specific assets and liabilities on the balance sheet or to specific firm commitments or anticipated transactions. The corporation also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivatives used are highly effective in offsetting changes in fair values or cash flows of hedged items. Hedge effectiveness of cash flows is achieved if the derivatives' cash flows substantially offset the cash flows of the hedged item and the timing of the cash flows is similar. Hedge effectiveness of fair values is achieved if changes in the fair value of the derivative substantially offset changes in the fair value of the item

hedged. If the above hedge criteria are not met, the derivative is accounted for on the consolidated balance sheet at fair value, with the initial fair value and subsequent changes in fair value recorded in earnings in the period of change.

If a derivative that has been accorded hedge accounting matures, expires, is sold, terminated or cancelled, and is not replaced as part of the corporation's hedging strategy, the termination gain or loss is deferred and recognized when the gain or loss on the item hedged is recognized. If a designated hedged item matures, expires, is sold, extinguished or terminated, and the hedged item is no longer probable of occurring, any previously deferred amounts associated with the hedging item are recognized in current earnings along with the corresponding gains or losses recognized on the hedged item. If a hedging relationship is terminated or ceases to be effective, hedge accounting is not applied to subsequent gains or losses. Any previously deferred amounts are carried forward and recognized in earnings in the same period as the hedged item.

NOTE
## 2. DISCONTINUED OPERATIONS

**A. D&R sale**

Effective Aug. 31, 2000, TransAlta Utilities sold its Distribution and Retail (D&R) operations, with a book value of $621.0 million to TEC in exchange for $855.1 million of preferred shares of TEC which were redeemed on Sept. 29, 2000. As the sale of the D&R operations from the corporation to TEC constituted a related party transaction, no gain on disposal was recorded and the $234.1 million excess of the proceeds received from TEC over the net book value of the D&R operations was recorded as contributed surplus. In 2000, pursuant to a Board of Directors' resolution, the contributed surplus was reclassified to retained earnings. In 2004, a regulatory decision relating to recovery of certain costs was issued that allowed TransAlta to finalize outstanding items relating to the sale of the D&R operations. As a result, $10.2 million of unused provision against closing costs has been released to income as a gain on disposal of discontinued operations ($6.8 million after tax). In addition, the redemption value of the preferred shares has been reduced by $10.2 million which, pursuant to the resolution of the Board of Directors, has been recorded as a charge to retained earnings. These adjustments were not made prior to 2004 as the corporation was awaiting a regulatory decision in order to finalize the purchase price.

In the fourth quarter of 2005, TransAlta Utilities settled a tax dispute over the timing of revenue recognition related to the sale of the D&R operations. This settlement resulted in the release of a $12.0 million tax provision and is shown as earnings from discontinued operations, net of tax on the statement of earnings.

**B. Transmission sale**

TransAlta Utilities sold its Transmission operations, with a book value of $632.8 million, to TEC on April 22, 2002. In exchange, TransAlta Utilities received preferred shares of TEC that were redeemable for $818.2 million. The sale of the Transmission operations to TEC constituted a related party transaction and therefore no gain on disposal was recorded. These preferred shares were redeemed on May 31, 2002 and the difference between the book value of the Transmission operations and the preferred shares was recorded as an adjustment to contributed surplus. In 2002, pursuant to a Board of Directors' resolution, the contributed surplus was reclassified to retained earnings. In June 2004, a settlement was reached to finalize the sale of the Transmission operations which resulted in an adjustment to the redemption value of the preferred shares of $2.1 million. The $2.1 million increased the redemption value of the preferred shares to $820.3 million and pursuant to a resolution of the Board of Directors, the adjustment has been charged to retained earnings.

NOTE
## 3. DISPOSALS - CONTINUING OPERATIONS

On May 9, 2003, the corporation finalized the sale of its head office building in Calgary, Alberta to an unrelated party for an agreed value of $65.8 million.

On July 18, 2003, the corporation sold its 50 per cent interest in the Sheerness Generating Station with a net book value of $435.8 million, to TEC in exchange for 6.75 per cent cumulative redeemable preferred shares with a face value of $630.0 million, which approximated the fair value of the Sheerness Generating Station. The exchange amount was determined based on an estimate of the future net cash flows of the Sheerness Generating Station. As the sale of this plant from the corporation to TEC constituted a related party transaction, no gain on disposal was recorded, and the $213.0 million in excess of proceeds received by the corporation over the net book value of the Sheerness Generating Station was recorded as contributed surplus. The corporation also transferred $3.7 million of asset retirement obligations and $15.1 million of working capital and future income tax liability.

NOTE

## 4. PROPERTY, PLANT AND EQUIPMENT

| | | 2005 | | | 2004 | | |
|---|---|---|---|---|---|---|---|
| | Depreciation rates | Cost | Accumulated depreciation | Net book value | Cost | Accumulated depreciation | Net book value |
| Thermal generation | 3% - 33% | **$1,765.8** | **$ 936.3** | **$ 829.5** | $ 1,676.3 | $ 887.2 | $ 789.1 |
| Mining property and equipment | 4% - 33% | **464.9** | **286.8** | **178.1** | 486.0 | 292.1 | 193.9 |
| Hydro generation | 2% - 5% | **347.1** | **197.1** | **150.0** | 342.0 | 189.1 | 152.9 |
| Thermal environmental equipment | 4% - 13% | **323.5** | **227.1** | **96.4** | 323.6 | 220.6 | 103.0 |
| Capital spares and other | 2% - 50% | **68.9** | **24.3** | **44.6** | 71.7 | 20.0 | 51.7 |
| Coal rights[1] | – | **67.9** | **15.3** | **52.6** | 70.8 | 15.3 | 55.5 |
| Land | – | **26.6** | **–** | **26.6** | 25.8 | – | 25.8 |
| Assets under construction | – | **10.7** | **–** | **10.7** | 10.7 | – | 10.7 |
| Transmission systems | 2% - 20% | **19.5** | **10.2** | **9.3** | 18.8 | 9.5 | 9.3 |
| | | **$3,094.9** | **$1,697.1** | **$1,397.8** | $ 3,025.7 | $ 1,633.8 | $ 1,391.9 |

1 *Coal rights are amortized on a unit of production basis, based on the estimated mine reserve.*

The corporation capitalized interest during construction of $3.4 million (2004 - $nil million) to assets under construction.

NOTE

## 5. ASSET RETIREMENT OBLIGATIONS

TransAlta Utilities has recorded an asset retirement obligation for all generating facilities, as it is legally required to remove the facilities at the end of their useful lives and restore the plant and mine sites to their original condition. For the hydro facilities, the corporation is required to remove the generating equipment, but is not legally required to remove the structures. TransAlta has recognized legal obligations arising from government legislation, written agreements between entities and case law. The asset retirement liabilities are recognized when the asset retirement obligation is incurred. Asset retirement liabilities for coal mines are incurred over time, as new areas are mined, and a portion of the liability is settled over time as areas are reclaimed prior to final pit reclamation.

A reconciliation between the opening and closing asset retirement obligations balance is provided below:

| | |
|---|---|
| Balance, Jan. 1, 2003 | $ 114.1 |
| Liabilities incurred in period | 9.5 |
| Liabilities settled in period | (10.4) |
| Accretion expense | 8.4 |
| Revisions in estimated cash flows | (23.5) |
| Balance, Dec. 31, 2004 | $ 98.1 |
| Liabilities incurred in period | 3.3 |
| Liabilities settled in period | (8.5) |
| Accretion expense | 8.4 |
| Revisions in estimated cash flows | 0.2 |
| **Balance, Dec. 31, 2005** | **$ 101.5** |

TransAlta Utilities estimates that the undiscounted amount of cash flow required to settle asset retirement obligations is approximately $377.8 million which will be incurred between 2007 and 2072. The majority of the costs will be incurred between 2020 and 2030. A discount rate of eight per cent was used to calculate the carrying value of the asset retirement obligations. No assets have been legally restricted for settlement of the liability.

NOTE

## 6. INTEREST INCOME

TransAlta Utilities has presented the corporation's preferred share investment as a long-term receivable on the consolidated balance sheet *(Note 1)*. Dividend income is included in interest income as shown below:

| | 2005 | 2004 |
|---|---|---|
| Interest income - preferred share investment in TEC | **$ 139.6** | $ 131.4 |
| Other interest income | **20.9** | 20.1 |
| Total interest income | **$ 160.5** | $ 151.5 |

NOTE

## 7. INTEREST EXPENSE

TransAlta Utilities' preferred securities are classified as financial liabilities on the consolidated balance sheet *(Note 1)*. Preferred securities distributions are included in interest expense as shown below:

| | 2005 | 2004 |
|---|---|---|
| Interest expense - preferred securities | **$ 138.7** | $ 138.6 |
| Interest on long-term debt | **56.8** | 56.3 |
| Total interest expense | **$ 195.5** | $ 194.9 |

NOTE

## 8. LONG-TERM RECEIVABLE FROM TRANSALTA ENERGY CORPORATION

In June 2004, TransAlta Utilities acquired a US$255.2 million preferred share investment in TEC using funds from a loan from TransAlta Corporation (TAC), the corporation's parent. The balance of the loan at Dec. 31, 2005 in Canadian dollars is $295.9 million (2004 - $312.7 million). The preferred shares bear a dividend rate of 5.8 per cent per annum and are redeemable at the option of the holder or issuer.

On July 18, 2003, in connection with the sale of the Sheerness Generating Station, the corporation received preferred shares in TEC for $630.0 million. These cumulative preferred shares hold a dividend rate of 6.75 per cent payable quarterly, and interest accrues and compounds on any unpaid dividends at a rate of 10.4 per cent per annum commencing 30 days following the date such unpaid dividends become payable. These shares are redeemable at the option of the corporation.

On May 3, 2001 as part of a capital restructuring, the corporation purchased preferred shares in TEC for $1.0 billion. These shares hold a dividend rate of 7.9 per cent and are paid quarterly. These shares are redeemable at the option of the corporation.

NOTE

## 9. SHORT-TERM DEBT

| | 2005 | | 2004 | |
|---|---|---|---|---|
| | Outstanding | Interest[1] | Outstanding | Interest[1] |
| Demand loan - TAC[2] | **$ 295.9** | **5.8%** | $ 312.7 | 5.8% |
| Bank debt | **3.5** | **–** | 1.8 | – |
| | **$ 299.4** | | $ 314.5 | |

1 *Interest is an average rate weighted by principal amounts outstanding.*

2 *In June 2004, TAC lent the corporation US$256.0 million. The outstanding principal amount and interest on the loan are due on demand on three business days notice.*

NOTE

## 10. LONG-TERM DEBT

### A. Amounts outstanding

| | 2005 | | 2004 | |
|---|---|---|---|---|
| | Outstanding | Interest rate[1] | Outstanding | Interest rate[1] |
| Preferred securities, due 2050 and 2052[2] | **$1,800.0** | **7.7%** | $ 1,800.0 | 7.7% |
| Debentures, due 2006 - 2033[3] | **515.1** | **6.1%** | 598.4 | 6.5% |
| Capital lease obligation, due 2005[4] | **–** | **–** | 0.8 | 8.0% |
| | **$2,315.1** | | $ 2,399.2 | |
| Less current portion | **100.0** | | 84.2 | |
| | **$2,215.1** | | $ 2,315.0 | |

1 *Interest is an average rate weighted by principal amount outstanding.*

2 *The preferred securities consist of $1.1 billion due in 2050 and $700.0 million due in 2052. The $1.1 billion are subordinated, unsecured and hold a dividend rate of 7.8 per cent which is paid quarterly. These preferred securities are redeemable at the option of the corporation in whole or in part on or after May 3, 2006 for a redemption amount equal to the subscription price plus accrued and unpaid dividends. The $700.0 million are subordinated, unsecured and hold a dividend rate of 7.5 per cent which is paid quarterly. These preferred securities are redeemable at the option of the holder (TAC) in whole or in part after the date of issue, for preferred shares at a subscription price of $25 per share. If converted, these preferred shares shall be redeemable in 2008 at the option of the corporation, in whole or in part for a redemption amount equal to the subscription price plus accrued and unpaid dividends. For both the amounts due in 2050 and 2052, interest accretion at the coupon rate is included in interest expense.*

3 *The debentures bear interest at fixed rates ranging from 5.5 per cent to 8.6 per cent. A floating charge on the property and assets of the corporation has been provided as collateral. Debentures of $150.0 million (2004 - $250.0 million) are held by TAC with an interest rate of 6.5 per cent and mature in 2009. Debentures of $100.0 million maturing in 2023 and $50.0 million maturing in 2033 are redeemable at the option of the holder in 2008 and 2009, respectively.*

4 *Certain coal mining capital assets have been provided as collateral. The maximum collateral amount equates the capital lease obligation. The obligation was due in 2005 at an eight percent fixed rate of interest.*

### B. Principal repayments

Long-term debt principal amounts are due in the following years:

| | |
|---|---|
| 2006 | $ 100.0 |
| 2007 | – |
| 2008 | 115.0 |
| 2009 | 150.0 |
| 2010 | – |
| 2011 and thereafter | 1,950.1 |
| | $ 2,315.1 |

### C. Letters of credit and guarantees

In the normal course of operations, TransAlta Utilities enters into agreements to provide financial or performance assurances to third parties. These include guarantees, letters of credit and surety bonds which are entered into to support or enhance creditworthiness in order to facilitate the extension of sufficient credit for construction projects and equipment purchases.

At Dec. 31, 2005, the corporation had $65.7 million (2004 - $59.8 million) in letters of credit outstanding and provided guarantees for TAC's issued commercial paper with a maximum exposure of $200.0 million (2004 - $200.0 million). All letters of credit expire in 2006. No surety bonds were outstanding at Dec. 31, 2005 or 2004.

At Dec. 31, 2005 the corporation had $50.0 million in letters of credit outstanding.

NOTE

## 11. SHARE CAPITAL

Common shares issued and outstanding

| | 2005 | | 2004 | |
|---|---|---|---|---|
| | Common shares (millions) | Amount | Common shares (millions) | Amount |
| Issued and outstanding, beginning of year | **135.0** | **$ 250.9** | 135.0 | $ 250.9 |
| Issued and outstanding, end of year | **135.0** | **$ 250.9** | 135.0 | $ 250.9 |

The corporation is authorized to issue an unlimited number of voting common shares without nominal or par value.

At Dec. 31, 2005, TransAlta Utilities had 135.0 million (2004 - 135.0 million) common shares issued and outstanding.

NOTE

## 12. INCOME TAXES

### A. Statement of earnings

I. Rate reconciliations

| | 2005 | 2004 |
|---|---|---|
| Earnings from continuing operations before income taxes | **$ 165.7** | $ 181.4 |
| Statutory Canadian federal and provincial income tax rate | **33.6%** | 33.9% |
| Expected taxes on income | **55.7** | 61.4 |
| Increase (decrease) in income taxes resulting from: | | |
| Non-taxable dividend income | **(46.9)** | (44.5) |
| Manufacturing and processing rate reduction | **(1.3)** | (1.7) |
| Effect of tax rate changes | **(1.9)** | (1.5) |
| Resource allowance net of non-deductible royalties | **(1.4)** | (1.6) |
| Resolution of uncertain tax positions | **(13.0)** | – |
| Large corporations tax net of surtax | **1.6** | 2.1 |
| Income tax expense | **$ (7.2)** | $ 14.2 |
| Effective tax rate | **(4.3%)** | 7.8% |

The corporation's operations are complex, and the computation and provision for income taxes involves tax interpretations, regulations and legislation that are continually changing. The corporation's tax filings are subject to audit by taxation authorities. The outcome of some audits may change the tax liability of the corporation and such adjustment could be material. Management believes it has adequately provided for income taxes based on all information currently available.

II. Components of income tax expense

| | 2005 | 2004 |
|---|---|---|
| Current tax expense | $ 5.1 | $ 26.4 |
| Future income tax expense related to the origination and reversal of temporary differences | (10.4) | (10.7) |
| Future income tax expense resulting from changes in tax rates or laws | (1.9) | (1.5) |
| Income tax expense | $ (7.2) | $ 14.2 |

**B. Balance sheets**

Significant components of the corporation's future income tax assets and liabilities are as follows:

| | 2005 | 2004 |
|---|---|---|
| Asset retirement obligation costs | $ 33.1 | $ 40.2 |
| Property, plant and equipment | (204.3) | (237.6) |
| Other deductible temporary differences | 7.5 | 8.4 |
| | $ (163.7) | $ (189.0) |

Presented in the balance sheet as follows:

| | 2005 | 2004 |
|---|---|---|
| Assets - current | $ 9.0 | $ 9.0 |
| Liabilities - long-term | (172.7) | (198.0) |
| | $ (163.7) | $ (189.0) |

NOTE

## 13. EMPLOYEE FUTURE BENEFITS

**A. Description**

The corporation has registered pension plans with defined benefit and defined contribution options and a supplemental defined benefit plan covering substantially all employees of the corporation. The defined benefit option of the registered pension plan ceased for new employees on June 30, 1998. The latest actuarial valuations of the registered and supplemental pension plans were as at Dec. 31, 2005. The measurement date used to determine plan assets and accrued benefit obligations was Dec. 31, 2005. The effective date of the next required valuation for funding purposes is Dec. 31, 2007. The supplemental pension plan is an obligation of the corporation. The corporation is not obligated to fund the supplemental plan but is obligated to pay benefits under the terms of the plan as they come due.

The corporation provides other health and dental benefits to the age of 65 for both disabled members (other post-employment benefits) and retired members (other post-retirement benefits). The latest actuarial valuation of these other plans was as at Dec. 31, 2004. The measurement date used to determine the accrued benefit obligation was at Dec. 31, 2005. The effective date of the next required valuation for funding purposes is Dec. 31, 2007.

**B. Costs recognized**

| Year ended Dec. 31, 2005 | Registered | Supplemental | Other | Total |
|---|---|---|---|---|
| Current service cost | $ 2.7 | $ 1.0 | $ 1.0 | $ 4.7 |
| Interest cost | 17.5 | 1.9 | 0.7 | 20.1 |
| Actual return on plan assets | (40.7) | – | – | (40.7) |
| Actuarial (gains) losses in 2005 | 22.0 | 4.4 | 0.6 | 27.0 |
| Difference between expected return and actual return on plan assets | 19.3 | – | – | 19.3 |
| Difference between actuarial (gain) loss recognized for the year and actual actuarial (gain) loss on accrued benefit obligation for the year | (20.3) | (4.1) | (0.6) | (25.0) |
| Difference between amortization of past service costs for the year and actual plan amendments for the year | (0.4) | 1.1 | 0.3 | 1.0 |
| Amortization of net transition obligation (asset) | (8.7) | 0.3 | – | (8.4) |
| Defined benefit (income) cost | (8.6) | 4.6 | 2.0 | (2.0) |
| Defined contribution option expense of registered pension plan | 5.1 | – | – | 5.1 |
| Net expense | $ (3.5) | $ 4.6 | $ 2.0 | $ 3.1 |

| Year ended Dec. 31, 2004 | Registered | Supplemental | Other | Total |
|---|---|---|---|---|
| Current service cost | $ 2.5 | $ 1.0 | $ 0.3 | $ 3.8 |
| Interest cost | 17.3 | 2.0 | 0.5 | 19.8 |
| Actual return on plan assets | (29.4) | – | – | (29.4) |
| Actuarial (gains) losses in 2004 | 11.3 | (1.4) | – | 9.9 |
| Plan amendments in 2004 | – | – | 3.5 | 3.5 |
| Difference between expected return and actual return on plan assets | 8.7 | – | – | 8.7 |
| Difference between actuarial (gain) loss recognized for the year and actual actuarial (gain) loss on accrued benefit obligation for the year | (9.8) | 1.8 | 0.2 | (7.8) |
| Difference between amortization of past service costs for the year and actual plan amendments for the year | 0.1 | (0.1) | (3.5) | (3.5) |
| Amortization of net transition obligation (asset) | (8.5) | 0.3 | – | (8.2) |
| Defined benefit (income) cost | (7.8) | 3.6 | 1.0 | (3.2) |
| Defined contribution option expense of registered pension plan | 3.7 | – | – | 3.7 |
| Net expense | $ (4.1) | $ 3.6 | $ 1.0 | $ 0.5 |

### C. Status of plans

| Year ended Dec. 31, 2005 | Registered | Supplemental | Other |
|---|---|---|---|
| Market value of plan assets | **$ 334.6** | **$ 1.7** | **$ –** |
| Accrued benefit obligation | **348.7** | **39.2** | **13.7** |
| Funded status - plan deficit | **$ (14.1)** | **$ (37.5)** | **$ (13.7)** |
| Amounts not yet recognized in financial statements: | | | |
| Unrecognized past service costs | **0.8** | **(1.5)** | **3.3** |
| Unamortized transition (asset) obligation | **(43.5)** | **2.5** | **–** |
| Unamortized net actuarial gains | **47.5** | **10.2** | **3.2** |
| Total recognized in financial statements: | | | |
| Accrued benefit liability | **$ (9.3)** | **$ (26.3)** | **$ (7.2)** |
| Amortization period in years (EARSL) | **8** | **8** | **17** |

| Year ended Dec. 31, 2004 | Registered | Supplemental | Other |
|---|---|---|---|
| Market value of plan assets | $ 316.9 | $ 1.3 | $ – |
| Accrued benefit obligation | 327.2 | 34.7 | 12.3 |
| Funded status - plan surplus (deficit) | $ (10.3) | $ (33.4) | $ (12.3) |
| Amounts not yet recognized in financial statements: | | | |
| Unrecognized past service costs | 0.4 | (0.4) | 3.5 |
| Unamortized transition (asset) obligation | (51.1) | 2.8 | – |
| Unamortized net actuarial gains | 45.4 | 6.8 | 2.9 |
| Total recognized in financial statements: | | | |
| Accrued benefit liability | $ (15.6) | $ (24.2) | $ (5.9) |
| Amortization period in years (EARSL) | 9 | 9 | 10 |

The classification of the accrued benefit liability on the consolidated balance sheet is as follows:

| Year ended Dec. 31, 2005 | Registered | Supplemental | Other |
|---|---|---|---|
| Accrued current liabilities | **$ 3.1** | **$ 0.5** | **$ 0.9** |
| Other long-term liabilities | **6.2** | **25.8** | **6.3** |
| Accrued benefit liability | **$ 9.3** | **$ 26.3** | **$ 7.2** |

| Year ended Dec. 31, 2004 | Registered | Supplemental | Other |
|---|---|---|---|
| Accrued current liabilities | $ – | $ 0.6 | $ 0.8 |
| Other long-term liabilities | 15.6 | 23.6 | 5.1 |
| Accrued benefit liability | $ 15.6 | $ 24.2 | $ 5.9 |

**D. Contributions**

Expected cash flows are as follows:

| | Registered | Supplemental | Other | Total |
|---|---|---|---|---|
| Employer contributions | | | | |
| 2006 (expected) | $ 6.9 | $ 0.5 | $ – | $ 7.4 |
| Expected benefit payments | | | | |
| 2006 | 21.6 | 1.6 | 0.9 | 24.1 |
| 2007 | 21.9 | 1.9 | 1.0 | 24.8 |
| 2008 | 22.2 | 1.9 | 1.0 | 25.1 |
| 2009 | 22.6 | 2.0 | 1.0 | 25.6 |
| 2010 | 23.0 | 2.2 | 1.0 | 26.2 |
| 2011 - 2015 | 118.9 | 12.3 | 5.8 | 137.0 |

**E. Reconciliation of plan assets**

| | Registered | Supplemental | Other |
|---|---|---|---|
| Fair value of plan assets at Dec. 31, 2003 | $ 311.3 | $ 0.8 | $ – |
| Contributions | – | 0.5 | – |
| Transfers to defined contribution option | (8.4) | – | – |
| Benefits paid | (22.1) | – | – |
| Actual return on plan assets | 36.1 | – | – |
| Fair value of plan assets at Dec. 31, 2004 | $ 316.9 | $ 1.3 | $ – |
| Contributions | – | 0.5 | – |
| Transfers to defined contribution option | 0.1 | – | – |
| Benefits paid | (23.0) | (0.1) | – |
| Actual return on plan assets | 40.7 | – | – |
| **Fair value of plan assets at Dec. 31, 2005** | **$ 334.7** | **$ 1.7** | **$ –** |

The corporation's investment policy is to achieve a consistently high investment return over time while maintaining an acceptable level of risk to satisfy the benefit obligations of the pension plans. The goal is to maintain a long-term rate of return on the fund that exceeds inflation by four per cent. The pension fund may be invested in publicly traded common or preferred equity shares, rights or warrants; convertible debentures or preferred securities; bonds, debentures, mortgages, notes or other debt instruments of government agencies or corporations; private company securities; guaranteed investment contracts; term deposits; cash or money market securities; and mutual or pooled funds eligible for pension fund investment. The target allocation percentages are 60 per cent equity and 40 per cent fixed income. Cash and money market instruments may be held from time to time as short-term investment decisions or as defensive reserves within the portfolios of each asset class. The fund may invest in derivatives for the purpose of hedging the portfolio or altering the desired mix of the fund. Derivative transactions that leverage the fund in any way are not permitted without the specific approval of the Pension Committee.

The allocation of plan assets by major asset category at Dec. 31, 2005 and 2004 is as follows:

| Year ended Dec. 31, 2005 | Registered | Supplemental |
|---|---|---|
| Equity securities | **61.2%** | **–** |
| Debt securities | **38.3%** | **–** |
| Cash equivalents | **0.5%** | **100.0%** |
| Total | **100.0%** | **100.0%** |

| Year ended Dec. 31, 2004 | Registered | Supplemental |
|---|---|---|
| Equity securities | 54.4% | – |
| Debt securities | 44.1% | – |
| Cash equivalents | 1.5% | 100.0% |
| Total | 100.0% | 100.0% |

Plan assets include common shares of the corporation having a fair value of $1.0 million at Dec. 31, 2005 (2004 - $0.7 million). The corporation charged the registered plan $0.1 million for administrative services provided for the year ended Dec. 31, 2005 (2004 - $0.1 million).

### F. Reconciliation of accrued benefit obligations

| | Registered | Supplemental | Other |
|---|---|---|---|
| Accrued benefit obligation as at Dec. 31, 2003 | $ 309.7 | $ 33.9 | $ 8.7 |
| Current service cost | 2.5 | 1.0 | 0.3 |
| Interest cost | 17.3 | 2.0 | 0.5 |
| Benefits paid | (20.6) | (1.5) | (1.0) |
| Past service charge | – | – | 3.5 |
| Actuarial loss (gain) | 18.3 | (0.7) | 0.3 |
| Accrued benefit obligation as at Dec. 31, 2004 | $ 327.2 | $ 34.7 | $ 12.3 |
| Current service cost | 2.7 | 1.0 | 1.0 |
| Interest cost | 17.5 | 1.9 | 0.7 |
| Expected benefits paid | (21.2) | (1.7) | (0.9) |
| Past service charge | 0.5 | (1.2) | – |
| Actuarial loss (gain) | 22.0 | 4.4 | 0.6 |
| **Accrued benefit obligation as at Dec. 31, 2005** | **$ 348.7** | **$ 39.1** | **$ 13.7** |

### G. Assumptions

The significant actuarial assumptions adopted in measuring the corporation's accrued benefit obligations were as follows:

| Year ended Dec. 31, 2005 | Registered | Supplemental | Other |
|---|---|---|---|
| Accrued benefit obligation as at Dec. 31 | | | |
| Discount rate | **5.5%** | **5.5%** | **5.5%** |
| Rate of compensation increase | **3.5%** | **3.5%** | **–** |
| Benefit cost for year ended Dec. 31 | | | |
| Discount rate | **5.8%** | **5.8%** | **5.8%** |
| Rate of compensation increase | **3.5%** | **3.5%** | **–** |
| Expected rate of return on plan assets | **7.0%** | **–** | **–** |
| Assumed health care cost trend rate at Dec. 31 | | | |
| Health care cost escalation | **–** | **–** | **9.5%**[1] |
| Dental care cost escalation | **–** | **–** | **4.0%** |
| Provincial health care premium escalation | **–** | **–** | **2.5%** |

| Year ended Dec. 31, 2004 | Registered | Supplemental | Other |
|---|---|---|---|
| Accrued benefit obligation as at Dec. 31 | | | |
| Discount rate | 5.5% | 5.5% | 5.5% |
| Rate of compensation increase | 3.5% | 3.5% | – |
| Benefit cost for year ended Dec. 31 | | | |
| Discount rate | 5.8% | 5.8% | 5.8% |
| Rate of compensation increase | 3.5% | 3.5% | – |
| Expected rate of return on plan assets | 7.0% | – | – |
| Assumed health care cost trend rate at Dec. 31 | | | |
| Health care cost escalation | – | – | 10.0%[1] |
| Dental care cost escalation | – | – | 4.0% |
| Provincial health care premium escalation | – | – | 2.5% |

1 *Decreasing gradually to 5.0 per cent by 2015 and remaining at that level thereafter.*

The expected long-term rate of return on plan assets is based on past performance and economic forecasts for the types of investments held by the plan. The estimated rate of return is lower than the historical returns of the appropriate indices.

Sensitivity to changes in assumed health care cost trend rates are as follows:

| | One percentage point increase | One percentage point decrease |
|---|---|---|
| Effect on total service and interest costs | $ 0.2 | $ (0.2) |
| Effect on post-retirement benefit obligation | $ 1.3 | $ (1.1) |

NOTE
## 14. FINANCIAL RISK MANAGEMENT

### A. Interest rate risk management

The fair value of the corporation's fixed interest long-term debt changes as interest rates change, with details as follows:

| | 2005 | | 2004 | |
|---|---|---|---|---|
| | Carrying amount | Fair value | Carrying amount | Fair value |
| Long-term debt | **$2,315.1** | **$2,397.1** | $ 2,399.2 | $ 2,421.8 |

### B. Foreign exchange risk management

The corporation has no future foreign currency obligations in 2005 (2004 - $nil).

### C. Credit risk management

The corporation actively manages its exposure to credit risk by assessing the ability of counterparties to fulfill their obligations under the related contracts prior to entering into such contracts, and continually monitors these exposures. The corporation makes detailed assessments of the credit quality of all counterparties and, where appropriate, obtains corporate guarantees and/or letters of credit to support the ultimate collection of these receivables. TransAlta Utilities is exposed to minimal credit risk for PPAs because under the terms of these arrangements all receivables are guaranteed by letters of credit.

NOTE
## 15. RELATED PARTY TRANSACTIONS

During the year, the corporation engaged in related party transactions with TAC and TEC. These transactions were recorded at their exchange amounts and settled under commercial terms. The exchange amounts are estimated based on rates and terms which would have been used for similar transactions with third parties or the amounts approximate cost. See Notes 2 and 3 for specific related party transactions regarding the sale of the D&R and Transmission operations and the sale of the Sheerness Generating Station.

### A. Transactions

| | 2005 | 2004 |
|---|---|---|
| **Operations, maintenance and administration expenses (income)** | | |
| TAC - administrative services | **$ 44.7** | $ 41.9 |
| TEC - management fees and other | **(0.2)** | (0.3) |
| **Interest expense** | | |
| TAC | **29.3** | 26.6 |
| Preferred securites | **138.7** | 138.6 |
| **Interest income** | | |
| TAC | **(20.9)** | (20.1) |
| Long-term receivable from TEC[1] | **(139.6)** | (131.4) |

1 *Interest income represents dividend income earned on the corporation's investment in TEC's preferred shares, presented as a long-term receivable from TEC.*

### B. Balances

The amounts due from (to) related parties, exclusive of related party debt *(Note 10)*, were as follows:

| | 2005 | 2004 |
|---|---|---|
| Accounts receivable (payable)[1] | | |
| TAC | **$ (27.1)** | $ (49.0) |
| TEC (including subsidiaries) | **0.2** | 4.3 |
| Interest receivable from TEC[2] | **116.6** | 68.3 |
| Loan receivable from TAC[3] | **354.6** | 305.6 |
| Long-term receivable from TEC[4] | **1,925.8** | 1,942.7 |

1 *The accounts receivable and accounts payable balances are due on demand and have arisen from the transactions referred to previously and are non-interest bearing.*

2 *Interest receivable represents dividend income earned on the corporation's investment in TEC's preferred shares, presented as a long-term receivable from TEC.*

3 *The loan receivable bears interest at bankers acceptance rates and has no fixed terms of repayment.*

4 *The long-term receivable represents the preferred share investment in TEC which consists of $1.0 billion of preferred shares purchased in 2001 as part of a capital restructuring, which hold a dividend rate of 7.9 per cent and $630.0 million in preferred shares received in 2003 in connection with the sale of Sheerness, which hold a dividend rate of 6.75 per cent. The aforementioned shares are redeemable at the option of the corporation. In June 2004, the corporation acquired an additional US$255.2 million ($295.9 million) preferred share investment in TEC which bears an annual interest rate of 5.8 per cent. This investment was funded through a demand loan with TAC for up to US$256.0 million which bears an annual interest rate of 5.8 per cent. These shares are redeemable at the option of the holder or issuer.*

NOTE
## 16. COMMITMENTS

Commencing Jan. 1, 2001, generation assets became subject to long-term PPAs for the estimated remaining life of each plant or unit. These PPAs set a production requirement and availability target to be supplied by each plant or unit and the price at which each MWh will be supplied to the customer. The expiry dates for the corporation's PPAs, other than the Wabumun facility, range from 2013 to 2020. The PPA for the Wabamun facility expired at the end of 2003 and production was sold on the spot market in 2004.

Approximate future payments under operating leases and mining agreements are as follows:

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 and thereafter | Total |
|---|---|---|---|---|---|---|---|
| Operating leases | 3.3 | 2.1 | 1.1 | 0.6 | 0.2 | 0.2 | 7.5 |
| Mining agreements | 8.8 | 8.9 | 5.3 | 5.4 | 5.3 | 71.5 | 105.2 |
| Total contractual obligations | $ 12.1 | $ 11.0 | $ 6.4 | $ 6.0 | $ 5.5 | $ 71.7 | $ 112.7 |

NOTE
## 17. OTHER CONTINGENCIES

On Dec. 16, 2002, the Canadian government ratified the Kyoto Protocol, which came into effect on Feb. 16, 2005. TransAlta Utilities is not able to estimate the full impact the Protocol will have on its operations, as the Canadian government has not yet established an implementation plan. However, the PPAs for TransAlta Utilities' coal-fired plants contain 'Change of Law' provisions that will provide an opportunity to recover compliance costs from the PPA customers.

The corporation is involved in various claims and legal actions arising from the normal course of business. The corporation does not expect that the outcome of these proceedings will have a material adverse effect on the corporation as a whole.

NOTE
## 18. SUPPLEMENTAL CASH FLOW INFORMATION

| | 2005 | 2004 |
|---|---|---|
| Depreciation and amortization expense per consolidated statements of earnings | **$ 88.1** | $ 82.1 |
| Mining equipment depreciation, included in fuel expense | **25.3** | 27.5 |
| Accretion expense, included in depreciation and amortization expense and fuel expense | **(8.5)** | (8.4) |
| Other | **0.2** | 1.8 |
| Depreciation and amortization expense per consolidated statements of cash flows | **$ 105.1** | $ 103.0 |

NOTE
## 19. COMPARATIVE FIGURES

Certain of the comparative figures have been reclassified to conform with the current year's presentation.

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